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E.O. 12958: DECL: 06/23/2031
TAGS: ECON EFIN PGOV HK CH
SUBJECT: COULD A "CHINA ENRON" HAPPEN IN HONG KONG?

Classified By: EP Section Chief Simon Schuchat; Reasons: 1.4 (b/d)

SUMMARY/COMMENT

¶1. (C) The expanding role of Hong Kong's stock market, now Asia's top location for raising new equity, underscores the importance of Hong Kong effectively vetting which firms list here and then regulating those companies in a manner that protects investor interests while also advancing China's economic liberalization and promoting regional financial stability. The contemplated listing by the Macau firm SJM -- associated with tycoon Stanley Ho, as well as allegations of money laundering -- demonstrates how events on Hong Kong's exchange, which to a significant degree is privately regulated, might potentially be of concern to U.S. policy makers. The Consul General recently held separate meetings with the head of Hong Kong's Security and Futures Commission (SFC) and Hong Kong Exchanges and Clearing (HKEx), the company that runs the stock exchange. He emphasized the importance of listing scrutiny to Hong Kong's reputation as a finance center, noting the pending SJM listing in this context. Both interlocutors described the thorough vetting required to go public here and emphasized the self-interest of Hong Kong and the mainland in preserving the exchange's strong reputation so that it can continue to serve as a catalyst for mainland firms to restructure and adopt global practices.

¶2. (C) There is no doubt that Hong Kong's exchange plays a positive role in promoting better corporate governance among mainland firms. However, the positive comments made to the CG by SFC and HKEx are not the whole story. The head of the Asian Corporate Governance Association told us of "Faustian bargains" made by HKEx to let mainland firms in the door, and he assessed that most mainland companies listing here would not dare go to New York, where they could be exposed to class action suits. Hong Kong's SFC lacks jurisdictional authority in China, and the SFC Chairman himself recognizes this as a pressing matter, given that most new listing business for the exchange comes from the mainland. Also of note is that many of the companies that list here represent China's shaky financial system or volatile sectors like energy and telecommunications. A significant downturn in China's economy might well lead to diminishing business prospects for these firms, and investor losses coupled with reports of malfeasance could well dent the exchange's ability to maintain its reputation as a center of quality geared to

matching emerging mainland firms with global investors. END SUMMARY/COMMENT

BACKGROUND -- A BOOMING EXCHANGE, THANKS TO CHINA
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¶3. (U) Hong Kong's stock market is eighth in the world by market capitalization, fourth in the world for equity raising (after New York, Toronto, and the Spanish Exchanges), and the top location in Asia for companies raising money through initial public offerings (IPOs) or follow-on fund raising activities. The world's top two IPOs over the past year both took place here: Bank of China and China Construction Bank, which together raised approximately USD 20 billion. New business for Hong Kong's stock exchange is overwhelmingly driven by listings from the mainland.

¶4. (U) "Going public" for mainland firms in Hong Kong involves issuing two kinds of shares, both well known to China-oriented investors: "H-shares" are stocks of Chinese-incorporated firms that trade in Hong Kong, such as PetroChina, China Life Insurance, and Air China; Red Chips are stocks of Hong Kong-based corporations that are substantially owned by entities affiliated with the Chinese government, including Lenovo and China Mobile. The Bank of China is an H-share; the Bank of China Hong Kong subsidiary (BOCHK) is a Red Chip.

¶5. (U) The issuance of shares by Red Chip and H-share companies has, since 1993, raised approximately USD 150 billion in funds and created USD 460 billion of market capitalization, 39 percent of the Hong Kong stock market's total, representing a range of key sectors. This in turn has provided significant volumes of cash to refine or expand the

business operations of major Chinese corporations (whose activities, depending on the firm, are both domestic and foreign) by attracting portfolio investment from foreign shareholders via Hong Kong.

REGULATOR: TOP CONCERN IS JURISDICTION

¶6. (C) In a meeting with the Consul General, Securities and Futures Commission (SFC) Chairman Martin Wheatley lamented that the Hong Kong's stock exchange's expansion is almost entirely reliant on companies that are resident in locations outside of local jurisdiction. This poses an enforcement challenge. Except for London and New York, other exchanges primarily serve companies in their geographical proximity. In Wheatley's assessment, mainland authorities are keen to ensure nothing goes wrong. All that said, Wheatley sees a new and riskier stage coming in regulating mainland firms; new companies from the mainland will increasingly be private in nature rather than state-owned enterprises (SOE). He explained that the Chinese government has actually done Hong Kong a favor by vetting SOEs before they even seek to list here. Such controls will not be in place for privately held firms, he said.

¶7. (C) Wheatley was less concerned about the ability of listing rules and procedures to filter out poor quality companies in the first place. He acknowledged that Hong Kong faces competitive pressure from aggressive exchanges like Singapore, and that there is some tension with the mainland exchanges (Shanghai, Shenzhen) that would like to start attracting new listings from China's blue chips. However, this does not translate into compromising the vetting process for the sake of getting new business, Wheatley asserted.

EXCHANGE: HIGH STANDARDS MEAN TURNING AWAY BUSINESS
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¶8. (C) Like Wheatley, HKEx Chief Executive Paul Chow underscored the pressure on Hong Kong from competing

exchanges. He had harsh words for Singapore, which in the last year has reached agreements with Shandong and Zhejiang provinces in China to set up what has been termed a "systematic channel" for listings of companies from those provinces. "We would never do that," he said while criticizing other exchanges for lowering their standards to get new business.

¶9. (C) Chow said Hong Kong's listing standards and vetting procedures are so lengthy that he fields numerous complaints from corporations frustrated by them. He criticized investment banks that put forward questionable firms that are unprepared to go public, leaving it to the exchange to play the unpleasant role of refusing them. Chow spoke almost enviously of Sarbanes-Oxley legislation (commonly referred to as SOX) in the U.S., assessing Hong Kong as not as tight on listing and regulation as the U.S. He is watching with interest the implications of SOX for U.S. exchanges and thinks all quality exchanges will ultimately have to move towards SOX-like regulation.

¶10. (C) In Chow's view, HKEx needs to emphasize quality at the expense of new business. This is key to China's economic development, since SOE restructuring cannot otherwise move forward successfully. HKEx could easily lower standards, but any event along the lines of Enron, Parmalat, or China Aviation Oil (a mainland firm whose collapse after undisclosed derivatives trading posed a major challenge last year to Singapore's exchange) would be a major setback. The proportion of individual investors in Hong Kong is higher than other places and HKEx's customers are critical by nature -- they expect protection because they are not professionals, he said.

¶11. (C) Chow said HKEx was branding itself in terms of quality and integrity. China will ultimately lift controls on its capital account, and many believe this will open the floodgates for listings in Shanghai that are geared to foreigners as well as locals, perhaps at Hong Kong's expense. But Chow is preparing for another scenario: cautioning that he could never say this publicly, he told the CG that capital account liberalization will actually mean that mainlanders will choose to put their money abroad, not in China, and they

will be particularly interested in investing in Hong Kong, based on the exchange's reputation as a host for premium Chinese companies, relative to Shanghai or Shenzhen.

MACAU'S SJM: A LISTING OF POTENTIAL CONCERN

¶12. (U) Macau tycoon Stanley Ho's monopoly on gambling in Macau came to in end in 2002, after 40 years. Facing new competition, Ho proceeded to carve a subsidiary out of his holdings called Sociedade de Jogos de Macau (SJM). Ho intends to list SJM publicly in Hong Kong, but in pursuing the listing, he has become embroiled in a dispute with minority shareholder (and sister) Winnie Ho; she has subsequently filed suit against her brother to block the listing.

¶13. (C) SJM's listing has subsequently been delayed. A local media report said the delay is tied to SFC's concerns about money laundering issues. VIP rooms in Ho's casinos have over time been associated with criminal activity, including money laundering. (Also of note: Ho also has a casino in North Korea.) The money laundering is best summed up by the 2006 International Narcotics Control Strategy Report, which states: "Under the old monopoly framework, organized crime groups were, and continue to be, associated with the gaming industry through their control of VIP gaming rooms and activities such as racketeering, loan sharking, and prostitution. The VIP rooms catered to clients seeking anonymity within Macau's gambling establishments and were removed from official scrutiny. As a result, the gaming

industry provided an avenue for the laundering of illicit funds and served as a conduit for the unmonitored transfer of funds out of China. Unlike SJM and new entrant Galaxy, the Sands (new American entrant to Macau) does not cede control of its VIP gaming facilities to outside organizations. This approach impedes organized crime's ability to penetrate the Sands operation."

¶14. (C) In his meetings with the SFC's Wheatley and HKEx's Chow, the CG noted concerns raised in hearings held by the U.S.-China Economic and Security Review Commission about firms going to Hong Kong instead of New York, allegedly because it is easier to list here. He noted the pending SJM IPO and emphasized the importance of rigorous listing procedures to Hong Kong's future role as a finance center. Both the SFC and HKEx said that local vetting standards are very high here and that Hong Kong is not sacrificing listing procedures to accommodate new business.

¶15. (C) Hong Kong already has one listed gaming company, Galaxy Entertainment (also named in the INCSR report quoted above). A Cambodian casino operator owned by Malaysian tycoon Chen Kip Keong, NagaCorp, also has plans to float shares in Hong Kong. Singapore and Hong Kong have previously rejected attempts by NagaCorp to list on their exchanges.

CONCERNS ABOUT HONG KONG'S EXCHANGE

¶16. (C) The Asian Corporate Governance Association (ACGA), based in Hong Kong, has made a name for itself regionally with its highly critical analysis and scorecards concerning corporate behavior throughout the region. ACGA Secretary General Jamie Allen gave us a generally positive assessment of Hong Kong's stock market, describing it as highly professional and not corrupt. Although Allen termed the exchange as the best in the region, specifically placing it above Singapore, he did express significant reservations about listing practices with regard to mainland firms that hold IPOs in Hong Kong.

¶17. (C) According to Allen, HKEx has over time adjusted its rules to accommodate mainland firms, entering into a series of "Faustian bargains." The exchange is motivated by a desire for new business, he said, and its officials do not really understand the corporate governance issues embedded in some of the firms that have listed here. The problem is exacerbated by second-tier investment banks -- specifically not the well-known U.S. houses operating here, he said -- that represent some of the more questionable firms that wish to issue stock in Hong Kong. These companies' managers have little idea of what listing requirements mean. In general,

however, the overall impact of preparing to list here is positive for the conduct of the mainland firms that do so, he said.

¶18. (C) Allen was critical of HKEx for bending or weakening numerous listing rules in recent years in order to accommodate mainland candidates. HKEx no longer has a profit requirement -- they now allow firms to qualify through market capitalization or revenue thresholds. HKEx has repeatedly offered waivers on compliance with important listing issues; for example, they have waived requirements that a certain number of directors be based in Hong Kong, thus opening the door to a situation where it may be difficult to field an investigation should something go wrong later on. There have also been numerous waivers issued with regard to disclosures of connected transactions (which occur when a public firm conducts significant business with a parent holding company; such business may affect the fortunes of minority shareholders). Disciplinary action is also very slow, lowering its deterrent value, said Allen; a firm that violated disclosure rules in 2003 is only now being sanctioned.

¶19. (U) ACGA in general has a mixed view of Hong Kong. Their snapshot report on the city notes that new listing rules implemented in 2004 are still lax with regard to the reporting of corporate results. ACGA assesses Hong Kong as having sound securities regulation, strong disclosure requirements on ownership, and detailed rules on the disclosure of connected transactions. However, despite Hong Kong's rule of law tradition, class action suits are not permitted. ACGA evaluates the SFC as independent and increasingly powerful and the anti-corruption commission (ICAC) as strong. They suggest, however, that the stock exchange is not robust in terms of enforcing its own rules. Private enforcement by shareholders is termed as weak, and high costs and unfavorable legal rules mean that minority shareholders see little to be gained from suing companies and directors in court.

WHY THEY DON'T GO TO NEW YORK

¶20. (C) We have on numerous occasions encountered contacts or seen media stories suggesting that recent listings by the Bank of China and China Construction Bank took place here and not in New York because of SOX. ACGA's Allen said this is only partially true and that SOX is really a subset of a larger issue: the right of U.S. shareholders to initiate class-action suits, something that cannot be done in Hong Kong. Allen said that top managers and directors of mainland SOEs know very well that their management structures are not under full control -- just look at all the malfeasance that has been reported at local branches of the large Chinese banks. Further, the mainland firms all watched China Life, which listed on the NYSE in 2003, become embroiled in shareholder suits. Some of these concerns have been aggravated by SOX, but the fundamental issue is that no top figure at an SOE wants to put himself in a position where a shareholder can hold him liable by bringing a class-action suit, said Allen.
Cunningham